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Perceptions of Auditees and Banks Regarding Financial Statement Audits: A Case for Portugal

FILIPA VERÍSSIMO CHOON
STUDENT N° 3150

A Project carried out on the Finance Course, within the Direct Research Internship Programme,
under the supervision of:

Professor Doctor Duarte Pitta Ferraz – Academic Advisor

Miguel Pinto Afonso – Business Advisor, KPMG Partner

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Abstract

KPMG (Direct Research Internship Programme) recommended the topic of the current empirical research, the objective of which is to uncover whether the market understands what auditing is, and if it recognizes the potential benefits of an (unqualified) audit report (e.g. to obtain more favourable loan conditions and to strengthen internal controls). The research also aims to uncover whether the market distinguishes on quality between the Big Four or a smaller firm.

The results of the semi-structured interviews (with eight company executives and six elite bankers) reveal that some businesses carry out an audit solely to comply, with larger firms more likely to engage voluntarily. Consistent with the literature, banks advocate the superior quality of the Big Four, although many SMEs use smaller firms. As for lending, not all enterprises believe banks offer more favourable conditions, yet banks argue auditors' unqualified opinion induce lower interest rates.

Keywords: external auditing, market perceptions, conditions of lending, Portugal

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1 Introduction

In 2015, the collective global audit revenues of the Big Four Accounting Firms (PwC, Deloitte, E&Y, and KPMG) surpassed \$45 billion (Butcher, 2016), which, comparatively speaking is greater than the GDP of either Tunisia or Slovenia in the last year (World Bank, 2017). From this figure, it is evident that auditing consumes a considerable amount of (financial) resources. But, what is an audit? Indeed, why are audits so relevant that they are required by law? Do stakeholders understand the value of external auditing? The aim of this empirical research is to examine the perceptions of some market participants regarding external auditing.

In answer to the first question: an audit is defined as the accumulation and assessment of evidence about information to conclude and report on the degree of similarity between the information and applicable criteria (Elder et al., 2010). Therefore, as suggested by the International Standard on Auditing 200, the purpose of an external audit is to enhance the degree of confidence of intended users in the financial statements of the company, through the emission of the auditor's opinion on whether they are prepared, in all material respects, in accordance with the applicable financial reporting framework. Thus, if the company follows the applicable framework, the auditors issue an "unqualified opinion" (vs a "qualified opinion").

As proposed by the second question presented above, auditing can be seen as essential such that often it is a legal requirement. Portuguese law requires virtually all medium and large corporations and all state-owned and public-interest entities to have their financial statements audited. Relevance is justified, therefore, by the inherent demand for an audit and the numerous benefits one brings.

The origin of modern auditing coincides with the Industrial Revolution in Great Britain at the end of the eighteenth century. This led to the development of large industrial corporations that required external capital to support further expansion, which implied an evident separation between capital providers and managers. This resulted in the need for company managers to report to the providers of funds on the financial outcomes attained; and this led to the need to ensure that those reports were reliable through an independent review (Hayes et al., 2014).

This highlights why external audits are necessary when companies grow in size (Abdel-Khalik, 1993). Firstly, as the number of transactions increases so does the likelihood of error and, as a result, auditors are required to detect these. Secondly, as the number of stakeholders increases, the more inefficient it becomes for each to review the financial statements individually and thus there is a need for a representative auditor (Porter et al., 2014). Thirdly, with the increasing number of players, conflicts of interest arise; therefore, as stated by Cohen et al. (2002), the audit is used as a monitoring tool, constituting an important part of the corporate governance panel, in the sense that it ensures sound financial reporting. Actually, external auditing constitutes one of three lines of defence that organizations own in order to manage risk, these are: the board or the operational management; the risk, compliance, and control areas; and the independent assurance providers, such as internal and external auditors (IIA, 2013; Arndorfer and Minto, 2015). Lastly, many companies issue debt to finance further growth and, as Chow (1982) suggests, accounting figures are essential for covenant determination; Chow's empirical analysis supports the hypothesis that the higher the level of leverage the more important these covenants are, so the need for transparent reporting increases. As to the benefits of auditing, the process is valuable for stakeholders as a whole, since auditing provides credibility to the financial information provided by the auditee. As auditors often present a list of additional observations comprising issues that can be improved, the reporting entity might also gain advantage from the auditor's work (Porter et al., 2014). The audit process is also beneficial to society as a whole, since transparent financial data enhances efficiency in capital allocation by helping investors and managers find value-creation opportunities. In the end, as Ball (2001) suggests, a strong reporting and disclosure system is a requirement for the existence of dynamic financial markets. Additionally, researchers such as Strawser (1994), find that companies with audited financial information are more likely to receive favourable loan decisions, in the form of lower interest rates and greater borrowing potential. The reasoning behind this is that, all things being equal, companies with audited accounts, particularly with unqualified opinions, vis-à-vis companies that do not, should have a lower credit risk, better internal rating, and, as a consequence, lower pricing.

Lastly, this empirical study explores the differences in the audit service provided by the Big Four vs the non-Big Four. Typically, the Big Four firms are viewed as providing better quality auditing services (Francis and Krishnan, 1999). The perception is that they deliver greater competence, owing to their huge investment in people. Additionally, as DeAngelo (1981) proposes, the Big Four tend to provide superior quality services because they have “more to lose” both in reputational matters and in terms of litigation costs.

There is a vast amount of literature and technical review on the definition of external auditing, its purpose, benefits, impact on bank loans, and finally, the difference between audit services provided by one of the Big Four vs a non-Big Four. Nevertheless, there is less research into how different market participants (e.g. shareholders, auditees, creditors, government agents, and suppliers) see external auditing. Furthermore, with recent scandals affecting this sector caused by the financial crisis, a study to gauge perceptions and the image of external auditing seems even more pertinent. Therefore, the purpose of this study is to collect explicit perceptions from companies and banks regarding external auditing. The method to support this research comprises interviews containing questions relative to the meaning, importance, and purpose of external auditing; its implications on bank loans, as well as the difference in quality, offered by the Big Four firms vs other auditing firms. The remainder of the research is organized as follows. Section 2 covers the main goals of the internship. Section 3 presents the literature review, which includes both previous theoretical and empirical analysis and, on the top of that, incorporates practical impressions derived from the internship. Section 4 consists of the methodology and the data. Section 5, by its turn, collates the results and elaborates on them. Section 6 concludes the analysis. Section 7 presents the implications of the results on the business world. And Section 8 closes the report with suggestions for future research.

2 Objectives of the Internship

NOVA School of Business and Economics implemented the DRI-type Working Project (hereafter WP) in order to allow students to gain professional experience while developing a dissertation. The idea is that the student takes advantage of contact with the business community and incorporates these insights into the research, enriching the analysis with a “real-world approach”. Actually, the topic of this thesis was born out

of a gap perceived in the business world while in the field, which relates to the poor understanding of the auditing profession. This has, in fact, already been found, for example by Strawser (1994), who mentions that users do not understand the nature of auditing and assurances provided by auditing engagements, and by Gray and Ratzinger (2010) who state that most members of the National Association of Investment Clubs could not name all the Big Four firms.

My personal internship at KPMG's Audit and Assurance department, aims to achieve two main objectives regarding this WP: the first goal is to clearly understand what external auditing is, and how it is performed; and the second objective is to capture the perceptions of the stakeholders in relation to external auditing. Hence, the analysis is limited by the number of interviewees and by the number of different interactions established during the internship.

3 Theory and Literature Review

Section 3 comprises extensive debate on matters of external auditing. The idea is to give support to the interview questions. It initiates with the origin of external auditing together with its definition. Following this, some reasoning is provided for why there is a legal obligation to have financial statements audited, and both the demand for auditing and the benefits of performing external auditing are considered. A debate is then presented as to whether the auditing of financial statements has any impact when borrowing credit from banks. Finally, a discussion about the differences in quality of an audit conducted by a Big Four firm vs other auditing companies is exhibited.

Origin and Definition

Ramamoorti (2003) points to evidence of audits dating to public systems in Babylonia, Greece, the Roman Empire, and the City States of Italy, all of which developed a detailed system of checks and counterchecks. Avoidance of accounting error as well as fraud by dishonest officials was the intention, this author suggests; showing how the emergence of external auditing is rooted in the necessity to have forms of independent verification to reduce bookkeeping errors, asset misappropriation, and fraud.

Modern auditing, however, can be traced back to the beginning of the Industrial Revolution in Britain, which originated the first big industrial organizations seeking external funds to manage growth. For the first time, there was a clear separation between capital providers and managers. Consequently, as proposed by the so-called Theory of Inspired Confidence, developed at the beginning of the twentieth century by the Dutch Professor Theodore Limperg, the demand for auditing increased as a result of the involvement of outside stakeholders. These stakeholders demanded accountability from management in return for their contribution to the company. As financial results presented by management might be biased, due to the likely presence of a conflict of interest, external auditing was necessary (Hayes et al., 2014). The practice of auditing has evolved in response to changes in the business environment. Today auditing can be defined, according to the Committee on Basic Auditing Concepts, as a systematic process of objectively gathering and evaluating evidence relating to assertions about economic actions and events in which the individual making the assertions has been engaged, to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to users of the reports in which the assertions are made.

Demand for External Auditing

As mentioned above, the growing separation between the interests of capital providers and the functions of management has increased demand for managers to report the firm's financial results to funders. Hence, hiring professional managers distinct from the owners of the firm both increases the need to communicate financial information while also presenting the need to have this communication audited, due to a set of factors which are as follows:

First there may be a conflict of interest between managers who, basically, report on their own performance, and the recipients of the financial information they supply. An audit provides reassurance that the executives have provided information that accurately reflects the company's financial affairs. The separation of roles has long been subject of research. Taurigana and Clarke (2000), for instance, point out that the lower the manager's share ownership in the firm, the greater the likelihood of the firm hiring external auditing. Similarly, Carey et al. (2000) find empirical support for the hypotheses that, in family-run businesses, the

larger the share of non-family management or non-family board members, the greater the demand for auditing. The second factor concerns the consequences that may arise due to accounting errors. If recipients of a company's financial statements base their decisions on untrustworthy figures, they could suffer severe financial losses. Therefore, before making decisions, requesting audited financial statements is prudent. This explains why researchers have found that a greater level of debt in the company can increase the likelihood that the company will hire the services of an auditor. As Tauringana and Clarke (2000) suggest, highly geared companies may be incentivized to carry out an audit, since lenders, i.e. banks, may request this, in order to avoid incurring financial losses. According to the same hypothesis, Chow (1982) argues that since accounting figures are highly relevant for determining covenants, hence the higher the level of leverage the more important these covenants are, and the more the need for transparent reporting. Naturally, the more reliant the covenants are on accounts information, the higher the probability of hiring external auditing, as Smith and Warner (1979) have pointed out. The third reason why examination of a company's financial information is crucial relates to the remoteness of information. In a modern, global economy, public companies have many shareholders and it is neither convenient nor efficient for such a large number of stockholders to validate the financial information themselves (likewise for the other stakeholders). Thus, for practical, physical, and economic factors, which prevent stakeholders from personally auditing the financial statements provided by the company, an independent party is necessary to review the information for them (Porter et al., 2014). Fourth, alongside company growth, the number of transactions also increases; and moreover, both economic transactions and accounting systems and rules become more complex. Thus, as the likelihood of making accounting errors increases, in order to avoid this, financial statements require examination by an independent qualified auditor. Yet, while the size-of-business argument has been intensively investigated it has delivered mixed results. Chow (1982), for example, finds moderate support for the predicted positive effect relating to firm size and external auditing. The empirical results of Abdel-Khalik (1993) support the hypothesis that voluntary demand for audit increases with the level of hierarchy (a metric relating to firm size). Depending on the metric of size (turnover and assets), Tauringana and Clarke (2000) find more or less favourable results

for the expected increase in auditing for bigger firms. Finally, Carey et al. (2000) do not find support for the size of business argument.

Benefits

The principle of external auditing – Providing Value – summarizes the benefits of auditing, as it is referred to in the Financial Reporting Council’s publication (2013):

“Auditors add to the reliability and quality of financial reporting; they provide to directors and officers constructive observations arising from the audit process; and thereby contribute to the effective operation of business, capital markets and the public sector.”

External auditing brings benefits to four main parties. First, it brings benefit to the actual users of the financial statements, the added value is associated with the credibility that auditing lends to the financial statements prepared by the auditee (Porter et al., 2014). Should the auditor detect material errors, which are referred to the management of the company but are not corrected, the auditor will draw attention to the errors by modifying opinion. In this way, users will know whether the financial statements are reliable and, if not, where the issues lay. In particular, and as suggested by Bushman and Smith (2003), shareholders benefit from having verifiable accounting information that facilitates their monitoring of management decisions, while also enabling directors to increase the value of the firm by reviewing and guiding the procedures of management.

Auditees are the second party to benefit, since, as the Financial Reporting Council suggests, auditors frequently issue a list of additional observations comprising points to be improved, specifically regards internal controls. Auditors gain detailed insight into the reporting company, its business and its accounting system, without being involved in the entity’s daily operations. From my own experience as an auditor at KPMG, I am able to confirm that, in fact, auditors frequently provide a set of practical observations and suggestions for improvements arising from the auditing process to help companies strengthen their internal controls.

The third party to benefit, although not obvious, is the management team of the audited company. According to Agency Theory, managers want the directors/shareholders to look favourably upon them, since managers are dependent on them for the success of the business and their jobs. In order to achieve this,

managers should produce reliable information; ergo managers are also incentivized to engage reputable auditors (Porter et al., 2014). It should be pointed out that in reality often managers and, in general, auditees' employees, however, do not perceive the importance of this activity.

Finally, the fourth party to benefit is society as a whole. Financial statement audits help to ensure the smooth functioning of financial markets as Turner (2001) suggested when he was Chief Accountant at the Securities and Exchange Commission in the USA:

“Capital is providing fuel for our economic engine, funding for the growth of new businesses, and providing job opportunities [...] Public trust begins, and ends, with the integrity of the numbers the public uses to form the basis for making their investment decisions [...] Accordingly, investors [...] have depended for over a hundred years on an independent third party, an external auditor, to examine the books and financial reports prepared by management.”

In other words, investment is crucial to the well-being of the economy; sustained investment relies on investors having confidence on the information provided by the reporting entity and, consequently, about the external auditing function. According to Bushman and Smith (2003), accessible and reliable financial accounting information enables executives and investors to identify and assess investment opportunities. Even in the absence of a conflict of interest, quality financial data enhances efficiency by aiding investors and managers to find value-creation opportunities. As Black (2000) and Ball (2001) suggest, a transparent reporting and disclosure system is a precondition of the existence of dynamic capital markets.

Implications for the Conditions of Lending

The intention of this section is to provide an overview to gauge whether audited accounts impact the decisions of commercial lenders, mainly in terms of internal credit rating and interest rates, and to understand if audited financial statements provide the auditee an additional benefit.

The internal credit rating of a client should imply (with other factors) a certain interest rate. Lenders apply credit ratings to assess the overall level of default risk of the firm. Hence, the more the risk the bank is bearing, the higher the return should be, i.e. the higher the interest rate charged and vice-versa. As Reeb et al. (2001) found, credit ratings play a major role in defining the cost of debt.

This has been a salient issue for some years now, particularly with the so-called Basel II and more recently Basel III Capital Accord, which requires financial institutions to use standardized measures of credit risk, market risk, and operational risk. Pillar 1 of this Accord sets minimum capital requirements for financial institutions to handle their risks (credit, market, and operational). Particularly for credit risk, banks may choose between two approaches to compute their required level of capital. The Standardized Methodology—as the name implies—evaluates credit risk based on a standardized method. Alternatively, financial institutions, with the approval of the banking regulator, may apply the Internal Ratings-Based (IRB) approach, i.e., institutions may use their internal rating systems for credit risk. These banks may use their own internal estimates of risk components, such as the probability of default and the loss given default to determine the capital requirement for a given exposure, which, ideally, implies more efficient capital allocation (Basel Committee on Banking Supervision, 2006).

In conclusion, besides other figures, regulators require banks to use external and, under the IRB approach, also internal ratings to define the overall risk-appetite and pricing of a certain borrower. Thus, this section seeks to understand whether auditors' opinions are a valuable input when assigning a credit rating to a firm, and ultimately, if this impacts lending conditions. This topic of internal ratings becomes even more relevant in the case of Portugal, where the majority of corporations do not have external rating.

The main argument is that, if external auditing lessens the monitoring costs of banks, as suggested by Watts and Zimmerman (1986), competition will steer lenders towards transferring these cost-reductions to borrowers through lower pricing schemes. In general, studies have found that companies with audited accounts are more likely to receive bank loans, since lenders associate greater reliability with audited statements (Balsam et al., 2003). With regard to the conditions of lending, Bamber and Stratton (1997) proposed that bankers associate uncertainty-modified audit reports with a greater likelihood of loan rejection, higher risk assessments, and higher interest rates. Strawser (1994), in turn, proposes that companies with financial audits are more likely to receive a more favourable loan decision. Moreover, Blackwell et al. (1998) assert that companies with audited accounts pay significantly lower interest rates than non-audited firms and

that the coefficient estimate suggests that an audited firm has, on average, reductions of 25 base points in their interest rates compared to an unaudited firm, *ceteris paribus*. According to Johnson et al. (1983), however, there is no relevant relation between loan interest rates and audited financial statements.

In conclusion, risk-return trade-off theory applied to banks suggests that lower credit rating should be associated with riskier loans; which, in turn, implies higher interest rates as compensation. Therefore if audited financial statements reduce client risk through their monitoring capacity, this ought to imply a lower interest rate and, as a matter of fact, most empirical analyses present consistent results in this regard.

By carrying out a series of interviews with companies, this dissertation seeks to understand what firms' perceptions are concerning interest-rate reductions associated with audited accounts. The interviews also seek to understand whether banks (both with and without the IRB approach), in fact, take auditing into account when attributing a certain credit rating to a client.

The Big Four vs Other Accounting Firms

Although public firms in Portugal are legally required to have audited financial statements, they need not hire one of the Big Four for the service; nonetheless, in 2014, the Big Four accounting firms audited more than 80 per cent of all listed companies in Portugal (Brochado, 2016). Hence, another question imposes itself on this study: are there differences in service quality between a Big Four accounting firm and a non-Big Four firm?

Francis and Krishnan (1999) find that the Big Four accounting firms are more conservative when issuing audit opinions. Further, there is evidence to suggest that investors have more confidence in the financial results of a firm whose external auditor is one of the Big Four, consistent with investors perceiving this information as being of higher quality (Teoh and Wong, 1993). It has also been shown that clients of the Big Four firms exhibit higher earnings quality through lower magnitude of discretionary accruals (Becker et al., 1998). To the extent that discretionary accruals capture opportunistic earnings management, this implies that the Big Four firms tolerate less earnings management than other auditors. Lawrence et al. (2011), in turn, controlled for the endogenous choice (i.e. auditing firms select the less risky clients with higher earnings quality beforehand) and the results indicate that companies audited by one of the Big Four present an audit quality

similar to that of non-Big Four clients. In a related study, Boone et al. (2010) find that Big Four and mid-tier accounting firms show similar audit quality, whereby audit quality is measured by the absolute value of discretionary accruals. A more recent study conducted by Eshleman and Guo (2014), however, suggests that companies audited by one of the Big Four are less likely to subsequently restate their earnings than clients of the non-Big Four, which is consistent with the Big Four firms offering superior quality audits. These authors argue that selecting the audit-quality proxy (they used the probability of a firm issuing an accounting restatement) is a basilar part of the analysis; they assert that previous research selected the incorrect proxies and, as a consequence, obtained different results.

In conclusion, one might argue that the Big Four firms in general offer superior quality of reporting. There is a body of literature that investigates the reasons for this phenomenon. The Big Four are perceived as delivering more quality based on their competence and independence: the competence argument is associated with their heavy spending on retention of talent; the independence relates to their large portfolio of clients, which is presumed to give them bargaining power to stand up to, or walk away from, a client if necessary.

In addition some researchers have suggested that the Big Four tend to deliver superior quality services as they have “more to lose” (DeAngelo, 1981). Two related arguments support this: one, the reputation hypothesis, suggests that among the Big Four excellence is key in retaining current clients, in attracting new clients, and in retaining and/or recruiting competent individuals; while there is also the deep-pockets hypothesis tested by Dye (1993), arguing that large firms of auditors offer superior quality because they have immense wealth exposed to risk in case of a lawsuit.

4 Methodology, Method, and Data

To collect information regarding the market’s understanding of auditing, two different market participants were interviewed: auditees (this group comprises both companies being currently audited and potential auditees) and banks.

Regards the auditees, there were eight interviewees across different industries: wine, restaurant, electronics, publicity, automotive, construction, public security, and education. Seven of these are private

companies and one is state-owned. Of the eight enterprises, three are large companies, four are medium, and one is small. The selected companies are distinct precisely to capture the different dynamics and behaviours. The participants were either CFOs (financial directors) or executive directors.

Among the banks were six interviewees, which represents virtually all retail banks in Portugal. Furthermore, participants were always C-level members with functions related to risk management or credit rating, given the questions being addressed.

The intention of the interviews was to gather explicit perceptions from the market, to then compare these with the findings of existing empirical studies, the statistical results of which infer a certain hypothesized consequence. Hence, a script was created to guarantee that both banks and companies addressed the same basic research questions, thus allowing a pattern to emerge of both the tendencies and the results.

- RQ1: What does auditing mean to you? In your opinion, what is the final purpose of a financial audit?
- RQ2: For some entities, auditing is mandatory. Does this make sense to you, given the benefits and the costs associated with hiring auditors?
- RQ3: Do you distinguish between the services of the Big Four accountants/auditors and non-Big Four?
Do you believe that the Big Four firms provide superior quality?

As for RQ4 and RQ5, they assumed different forms according to the group of participants.

- RQ4 (Companies): Has your bank ever asked you for an audit report to lend, or renew your credit? For some banks, this influences the internal rating and consequently the pricing, did you know that? Have you ever noticed that?
- RQ5 (companies): Does your institution have a business plan? Has your bank ever required you that in order to lend you money? Or do they only ask for historical information?
- RQ4 (banks): Do you find audited financial statements relevant when analysing a client's credit rating? Does an audit, particularly with unqualified (vs qualified) opinion affect the credit rating? Is the rating reflected further in different pricing and conditions of lending?

RQ5 (banks): Is it important for the bank that clients have a business plan? Do you require a business plan in order to lend the client money?

It is noteworthy that semi-structured interviews provide the opportunity to excavate deeper into certain questions; that is, the research questions guide the interview, but provide the opportunity to further explore certain themes as well.

The interviews were conducted individually, to give the participant room to share his/her opinions, and in Portuguese (the interviewees' native language) to allow more fluency of language, discussion, and presentation of ideas. The duration of the interviews ranged between approximately fifteen and thirty minutes.

Before each interview, the purpose of the study was presented and the participants were told that the interview would be recorded (and destroyed at the end), and that participation was anonymous and confidential (thus names and institutions would never be mentioned).

5 Results

This section provides a synopsis of the interviews. Semi-structured interviews constitute part of a set of qualitative methods and, as such, numeric statistics have only slight applicability.

It presents the more conceptual questions about external audits (meaning, purpose, and importance) first, followed by questions that address specific aspects of the Big Four accounting firms vs the non-Big Four. The subsequent question seeks to understand to what extent external audits (with unqualified opinions) reduce the cost of debt for companies. To conclude, the final research question tries to capture the relevance and pertinence of future research in relation to the importance of a business plan (the same way this project addressees auditing). The business plan seems particularly pertinent, since survival without a strong business plan and a clear prospective vision would seem virtually impossible in a highly competitive global market.

In response to RQ1, all eight auditee participants agreed that the purpose of auditing is to heighten the confidence of financial statements' users, in fact, three interviewees mentioned the words external image, credibility, or security, which, constitute part of the final goal of an audit. However, only one participant mentioned that auditors verify whether the company is complying with the legally applicable framework.

Further, two participants referred to the fact that auditors also help companies make more appropriate decisions, as they issue a list of additional observations. This is aligned with the argument previously presented, that auditees benefit from the points of improvement proposed by an auditor. In conclusion, the majority understood the goal of the audit, yet, only four of them engage in audits voluntarily or for both reasons (i.e. company choice as well as a legal requirement). Interestingly, the small company did not have an audit and the medium companies typically engaged solely because it is mandatory, which means that for smaller companies the benefits of an audit might not compensate the cost. As predicted by Abdel-Khalik (1993), the voluntary demand for external auditing increases with firm size. Similarly, all the interviewees of the banks group agreed that the purpose of auditing is to augment the confidence of the users of the financial statements. In particular, four interviewees used the words transparency, security, and credibility; and two talked about standardization of applicable norms and comparability.

In response to RQ2, all respondents find the applicable legal requirements fair and acceptable. Nonetheless, three company interviewees mentioned that it seems not to work in some cases, namely Enron or, in Portugal, the more recent scandals involving banks. One participant stated, "... in practice, with all the problems that arose from the financial crisis, the audit as a control mechanism has been shown not always to work effectively."

The responses to RQ3 are mixed. On the one hand, a few company interviewees agree that the Big Four offer superior quality; others advocate the smaller audit firms are actually able to deliver a more flexible, customized, continuous and timely service and refer to the cost advantage of hiring this service. On the other hand, banker interviewees generally believe that the Big Four offer superior audit quality, which agrees with the findings of Teoh and Wong (1993) that investors have more confidence in the financial results of an enterprise audited by one of the Big Four. In addition, this same group refers to the higher exigence imposed by the Big Four firms (Francis and Krishnan, 1999; Eshleman and Guo, 2014), which, as empirically predicted, is related to the Big Four having "more to lose" (DeAngelo, 1981). Further, some of this same group suggest that the Big Four have superior experience, implying greater efficiency and knowledge about

diverse markets. Lastly this group refer to the lack of independence of some smaller auditing companies, as previously discussed. One banker even suggests that “[for smaller auditing firms] each client represents a relevant weight on the company revenues, which may make the firm less independent, which ultimately induces less confidence.” Another of the bankers, however, states that “For SMEs, investing in a Big Four audit might not be compensatory and, on the top of that, audit practices should be clear and uniform.”

In response to RQ4, all companies were requested by the lender to present an audit report when borrowing money; except for the state-owned company, which is not authorized to borrow money from commercial banks, and the small company that does not hire an external audit. With regard to the impact on the internal rating and on the interest rate, of the six companies that do carry out audits, the majority agree that having an unqualified opinion is advantageous. They suggest that banks’ increased confidence in company’s accounts, due to the audit report, induces more favourable conditions. One participant illustrates this, saying: “When, twenty years ago, this company started having external audits, we felt a decrease in our interest rate of almost 1 per cent.” This view is not shared among all participants; a number do not notice any impact on the interest rate and one argues that, unavoidably, banks have two dissimilar interests which do not allow a direct relation between credit rating and interest rate: on one hand there is the commercial area that generates business, on the other, the area sensitive to risk, which mitigates client risk through higher interest rates.

The response of the banks regards whether financial statements are relevant when analysing a client’s credit rating produces results that are even more interesting. There is general consensus that having an unqualified opinion (vs having no auditor opinion) has a positive effect on the internal rating, while one participant mentions that although it is indeed relevant, the model of the bank does not yet incorporate this. For the others, it seems, in fact, that the quality of the financial statements impacts on credit rating, but this impact varies according to the size of the company. One banking expert states at length, “For smaller companies we do not pay that much of attention to the quality of the financial statements, but instead to the behaviour of the client (e.g. usual cash flows and historical performance). However, with the larger companies, less consideration is given to behavioural aspects and more to the financial and, this way, the audit

report gains more applicability”. This is consistent with small companies not being asked for an audit report. It is also noteworthy that all IRB banks have models that include the quality of the audit in the final rating.

The bankers agree that having audited accounts translates into better conditions of lending, specifically to a more favourable interest rate. This is consistent with the empirical result of Blackwell et al. (1998) that companies with external auditing pay lower interest rates. One director of a bank illustrated directly this relationship of risk–price, with the following explanation: “Credit has two different vectors that work in parallel and communicate. The assessment of risk (i.e. the capacity that a company has to support a certain level of debt) and the PAR (Pricing Adjusted to Risk), which incorporates the risk into the price. Commercial have, then, some latitude (between defined caps and floors) to change the reference price.” As some interviewees explained, banks depart from an issuer rating (not a transaction rating) and, based on a set of additional factors – e.g. the opinion of the auditor, type of exposure, maturity, collaterals, and guarantees – set the price.

Finally, in response to RQ5 concerning whether it is important for the bank that clients have a business plan, there seems to be room for progress. Firstly, there are still companies that do not have a business plan and, consequently, do not know whether the company is capable of remaining in the market in its current way of operating. Half of companies interviewed did not have a business plan, and among those, only the small enterprise is developing one. For the companies with a business plan, they are commonly three–five years ahead. Banks, in turn, request the business plan only for special operations, such as projects that are marginal to the normal activity of the company, companies experiencing financial difficulty or restructuring, and when the past is not a solid reference for the future of the company. This finding is in line with the results relating to companies, which suggest that generally banks do not ask for their business plans. Therefore, banks lose an important tool to forecast whether the company will be able to repay the debt and all the supplementary service costs.

6 Conclusions

The topic of the project was appointed by KPMG under the Direct Research Internship Programme, because, despite a large body of theoretical and empirical literature about external auditing, few studies have gathered explicit perceptions regarding financial statement audits specifically in Portugal. The semi-structured interviews conducted and analysed in this dissertation – eight company executives and six elite bankers – suggest that companies and banks have different opinions about auditing, and companies typically do not recognize the potential benefits of auditing – the increased ability to raise capital, the more favourable loan conditions, and the benefits of stronger internal controls – and, as such, only hire the service because it is mandatory. This is consistent with the perception of the business world-related issue I encountered while working as an auditor at KPMG, which ended up instigating this study – companies have a poor understanding of external auditing.

Regards the broad activity of auditing, all respondents agree that the ultimate purpose of the audit process is to enhance users' confidence in the financial statements of companies; however, few people correctly explained what auditors do in reality. Moreover, generally, companies engage in audit services when it is mandatory; that is, they are not confident that the benefit of an audit will surpass the cost. Interestingly enough, consistent with Abdel-Khalik (1993), the larger the company the greater the (voluntary) demand for this service. All participants find the Law regarding mandatory audits acceptable, although some refer to the recent reputational scandals of auditing companies associated with the financial crisis. Although the literature suggests that the Big Four accounting firms offer a superior auditing service (e.g. Eshleman and Guo, 2014), the results suggest that most of the companies interviewed disagree, and find smaller auditing companies more suitable for reasons including flexibility, timely service, and cost benefit. Banks, on the contrary, advocate the superior quality of the Big Four. Concerning the conditions of lending, particularly with regard to price, there is a gap of perception between companies and banks. Some enterprises believe that banks offer more favourable conditions because of their unqualified audit report (without material misstatements), while others do not believe it has any impact, arguing that banks have an inherent misalignment of interests (risk vs

commercial) that does not allow lower risk to directly reflect lower interest rate. All banks, in turn, argue that unqualified opinions induce lower risk and, consequently, lower interest rate, as predicted by Blackwell et al. (1998).

7 Impact on the Business World

In general these results imply sparse knowledge of external audits among the Portuguese business community, which might induce companies to underestimate its utility and make incorrect use of the service. To address this in the business world, I propose including auditing subjects – e.g. definition, demand, and benefits – in auditing courses, both academic and practical, in universities and in auditing firms, in Portugal. If no such course modules on auditing are available at present, I propose that business and accounting universities should implement them, not only for future auditors, but also for future managers and accountants.

8 Limitations and Suggested Future Research

The findings discussed should be considered in light of their limitations. Although the companies interviewed represent a relevant diversity of size and industries, it is still a small sample and the participants are volunteers. The same applies for the group of banks, the sample covers the majority of the banks in Portugal, but, again, the sample is small and not random. Therefore, the results drawn above should be viewed as introductory and as a starting point for future research. First, it would enrich the research to extend the analysis presented here to other market participants, such as shareholders, governments, and regulators. It would also be pertinent to perform similar analysis with focus on business plans, which, as earlier stated, is still underdeveloped in Portugal. Second, quantitative research on issues raised in the results could reveal what appears to be a pattern between the size of the company and the demand for auditing services, but very few quantitative analyses have been performed in this field in Portugal. Additionally, some companies argue that smaller accounting firms would better suit their requirements, and hence a study of the relation between the accounting firm dimension and the auditee size may be relevant. Lastly, further research might be directed to clearly understand whether, in Portugal, banks do in fact infer more favourable conditions for clients with an external audit (unqualified) opinion.

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10 Appendices

Appendix I – Companies' Results

	RQ1: Does the participant suggest that the final purpose of auditing is to enhance the confidence of the users of FS?		RQ2: Does the interviewee find the legal imposition of audit acceptable?		RQ3: Does the participant believe that Big 4 accounting firms offer superior quality?		RQ4: Does the interviewee say that banks require the company's audit report to lend money?		RQ4: Does the participant believe that banks offer more favourable lending conditions when companies have unqualified audit reports?		RQ5: Does the participant's company have a business plan?		RQ5: Does the interviewee say that banks require the company's business plan to lend money?	
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
#	8	0	8	0	3	5	6	2	4	4	4	4	2	6
%	100%	0%	100%	0%	38%	63%	75%	25%	50%	50%	50%	50%	25%	75%

Appendix II – Banks' Results

	RQ1: Does the participant suggest that the final purpose of auditing is to enhance the confidence of the users of FS?		RQ2: Does the interviewee find the legal imposition of audit acceptable?		RQ3: Does the participant believe that Big 4 accounting firms offer superior quality?		RQ4: Does the participant's bank take into account auditor's opinion when attributing a credit rating to a company?		RQ4: Does the participant's bank reflect unqualified opinions into more favourable lending decisions?		RQ5: Does the participant find business plans relevant when lending money?		RQ5: Does the interviewee mention that his/her institution require the company's business plan to lend money?	
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
#	6	0	6	0	4	2	5	1	6	0	6	0	4	2
%	100%	0%	100%	0%	67%	33%	83%	17%	100%	0%	100%	0%	67%	33%